



[4830-01-p]

## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-136978-12]

RIN 1545-BL22

Fractions Rule

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the application of section 514(c)(9)(E) of the Internal Revenue Code (Code) to partnerships that hold debt-financed real property and have one or more (but not all) qualified tax-exempt organization partners within the meaning of section 514(c)(9)(C). The proposed regulations amend the current regulations under section 514(c)(9)(E) to allow certain allocations resulting from specified common business practices to comply with the rules under section 514(c)(9)(E). These regulations affect partnerships with qualified tax-exempt organization partners and their partners.

DATES: Written and electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-136978-12), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8

a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-136978-12), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically, via the Federal eRulemaking Portal site at <http://www.regulations.gov> (indicate IRS and REG-136978-12).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Caroline E. Hay at (202) 317-5279; concerning the submissions of comments and requests for a public hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### **Background**

This document proposes amendments to the Income Tax Regulations (26 CFR part 1) under section 514(c)(9)(E) regarding the application of the fractions rule (as defined in the Background section of this preamble) to partnerships that hold debt-financed real property and have one or more (but not all) qualified tax-exempt organization partners.

In general, section 511 imposes a tax on the unrelated business taxable income (UBTI) of tax-exempt organizations. Section 514(a) defines UBTI to include a specified percentage of the gross income derived from debt-financed property described in section 514(b). Section 514(c)(9)(A) generally excepts from UBTI income derived from debt-financed real property acquired or improved by certain qualified organizations (QOs) described in section 514(c)(9)(C). Under section 514(c)(9)(C), a QO includes an educational organization described in section 170(b)(1)(A)(ii) and its affiliated support organizations described in section 509(a)(3), any trust which constitutes a qualified trust

under section 401, an organization described in section 501(c)(25), and a retirement income account described in section 403(b)(9).

Section 514(c)(9)(B)(vi) provides that the exception from UBTI in section 514(c)(9)(A) does not apply if a QO owns an interest in a partnership that holds debt-financed real property (the partnership limitation), unless the partnership meets one of the following requirements: (1) all of the partners of the partnership are QOs, (2) each allocation to a QO is a qualified allocation (within the meaning of section 168(h)(6)), or (3) each partnership allocation has substantial economic effect under section 704(b)(2) and satisfies section 514(c)(9)(E)(i)(I) (the fractions rule).

A partnership allocation satisfies the fractions rule if the allocation of items to any partner that is a QO does not result in that partner having a share of overall partnership income for any taxable year greater than that partner's fractions rule percentage (the partner's share of overall partnership loss for the taxable year for which the partner's loss share is the smallest). Section 1.514(c)-2(c)(1) describes overall partnership income as the amount by which the aggregate items of partnership income and gain for the taxable year exceed the aggregate items of partnership loss and deduction for the year. Overall partnership loss is the amount by which the aggregate items of partnership loss and deduction for the taxable year exceed the aggregate items of partnership income and gain for the year.

Generally, under §1.514(c)-2(b)(2)(i), a partnership must satisfy the fractions rule both on a prospective basis and on an actual basis for each taxable year of the partnership, beginning with the first taxable year of the partnership in which the partnership holds debt-financed real property and has a QO partner. However, certain

allocations are taken into account for purposes of determining overall partnership income or loss only when actually made, and do not create an immediate violation of the fractions rule. See §1.514(c)-2(b)(2)(i). Certain other allocations are disregarded for purposes of making fractions rule calculations. See, for example, §1.514(c)-2(d) (reasonable preferred returns and reasonable guaranteed payments), §1.514(c)-2(e) (certain chargebacks and offsets), §1.514(c)-2(f) (reasonable partner-specific items of deduction and loss), §1.514(c)-2(g) (unlikely losses and deductions), and §1.514(c)-2(k)(3) (certain de minimis allocations of losses and deductions). In addition, §1.514(c)-2(k)(1) provides that changes in partnership allocations that result from transfers or shifts of partnership interests (other than transfers from a QO to another QO) will be closely scrutinized, but generally will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years. Section 1.514(c)-2(m) provides special rules for applying the fractions rule to tiered partnerships.

The Treasury Department and the IRS have received comments requesting targeted changes to the existing regulations under section 514(c)(9)(E) to allow certain allocations resulting from specified common business practices to comply with the rules under section 514(c)(9)(E). Section 514(c)(9)(E)(iii) grants the Secretary authority to prescribe regulations as may be necessary to carry out the purposes of section 514(c)(9)(E), including regulations that may provide for the exclusion or segregation of items. In response to comments and under the regulatory authority in section 514(c)(9)(E), these proposed regulations provide guidance in determining a partner's share of overall partnership income or loss for purposes of the fractions rule, including

allowing allocations consistent with common arrangements involving preferred returns, partner-specific expenditures, unlikely losses, and chargebacks of partner-specific expenditures and unlikely losses. The proposed regulations also simplify one of the examples involving tiered partnerships and provide rules regarding changes to partnership allocations as a result of capital commitment defaults and later acquisitions of partnership interests. These proposed regulations except from applying the fractions rule certain partnerships in which all partners other than QOs own five percent or less of the capital or profits interests in the partnership. Finally, these proposed regulations increase the threshold for de minimis allocations away from QO partners.

## **Explanation of Provisions**

### **1. Preferred Returns**

Section 1.514(c)-2(d)(1) and (2) of the existing regulations disregard in computing overall partnership income for purposes of the fractions rule items of income (including gross income) and gain that may be allocated to a partner with respect to a current or cumulative reasonable preferred return for capital (including allocations of minimum gain attributable to nonrecourse liability (or partner nonrecourse debt) proceeds distributed to the partner as a reasonable preferred return) if that preferred return is set forth in a binding, written partnership agreement. Section 1.514(c)-2(d)(2) of the existing regulations also provides that if a partnership agreement provides for a reasonable preferred return with an allocation of what would otherwise be overall partnership income, items comprising that allocation are disregarded in computing overall partnership income for purposes of the fractions rule.

Section 1.514(c)-2(d)(6)(i) of the existing regulations limits the amount of income and gain allocated with respect to a preferred return that can be disregarded for purposes of the fractions rule to: (A) the aggregate of the amount that has been distributed to the partner as a reasonable preferred return for the taxable year of the allocation and prior taxable years, on or before the due date (not including extensions) for filing the partnership's return for the taxable year of the allocation; minus (B) the aggregate amount of corresponding income and gain (and what would otherwise be overall partnership income) allocated to the partner in all prior years. Thus, this rule requires a current distribution of preferred returns for the allocations of income with respect to those preferred returns to be disregarded.

The Treasury Department and the IRS have received comments requesting that the current distribution requirement be eliminated from the regulations because it interferes with normal market practice, creates unnecessary complication, and, in some cases, causes economic distortions for partnerships with QO partners. The preamble to the existing final regulations under section 514(c)(9)(E) responded to objections regarding the current distribution requirement by explaining that if the requirement were eliminated, partnerships might attempt to optimize their overall economics by allocating significant amounts of partnership income and gain to QOs in the form of preferred returns. The preamble explained that these allocations "would be a departure from the normal commercial practice followed by partnerships in which the money partners are generally subject to income tax." TD 8539, 59 FR 24924. A recent commenter explained that the vast majority of partnerships holding debt-financed real property (real estate partnerships) with preferred returns to investing partners (either the QO or the

taxable partner) make allocations that match the preferred return as it accrues, without regard to whether cash has been distributed with respect to the preferred return. Instead of requiring distributions equal to the full amount of their preferred returns, taxable partners generally negotiate for tax distributions to pay any tax liabilities associated with their partnership interest.

The Treasury Department and the IRS have reconsidered the necessity of the current distribution requirement to prevent abuses of the fractions rule. So long as the preferred return is required to be distributed prior to other distributions (with an exception for certain distributions intended to facilitate the payment of taxes) and any undistributed amount compounds, the likelihood of abuse is minimized. Therefore, the proposed regulations remove the current distribution requirement and instead disregard allocations of items of income and gain with respect to a preferred return for purposes of the fractions rule, but only if the partnership agreement requires that the partnership make distributions first to pay any accrued, cumulative, and compounding unpaid preferred return to the extent such accrued but unpaid preferred return has not otherwise been reversed by an allocation of loss prior to such distribution (preferred return distribution requirement). The preferred return distribution requirement, however, is subject to an exception under the proposed regulations that allows distributions intended to facilitate partner payment of taxes imposed on the partner's allocable share of partnership income or gain, if the distributions are made pursuant to a provision in the partnership agreement, are treated as an advance against distributions to which the distributee partner would otherwise be entitled under the partnership agreement, and do not exceed the distributee partner's allocable share of net partnership income and gain

multiplied by the sum of the highest statutory federal, state, and local tax rates applicable to that partner.

## 2. Partner-Specific Expenditures and Management Fees

Section 1.514(c)-2(f) of the existing regulations provides a list of certain partner-specific expenditures that are disregarded in computing overall partnership income or loss for purposes of the fractions rule. These expenditures include expenditures attributable to a partner for additional record-keeping and accounting costs including in connection with the transfer of a partnership interest, additional administrative costs from having a foreign partner, and state and local taxes. The Treasury Department and the IRS are aware that some real estate partnerships allow investing partners to negotiate for management and similar fees paid to the general partner that differ from fees paid with respect to investments by other partners. These fees include the general partner's fees for managing the partnership and may include fees paid in connection with the acquisition, disposition, or refinancing of an investment. Compliance with the fractions rule may preclude a real estate partnership with QO partners from allocating deductions attributable to these management expenses in a manner that follows the economic fee arrangement because the fractions rule limits the ability of the partnership to make disproportionate allocations.

The Treasury Department and the IRS have determined that real estate partnerships with QO partners should be permitted to allocate management and similar fees among partners to reflect the manner in which the partners agreed to bear the expense without causing a fractions rule violation. Accordingly, the proposed regulations add management (and similar) fees to the current list of excluded partner-



specific expenditures in §1.514(c)-2(f) of the existing regulations to the extent such fees do not, in the aggregate, exceed two percent of the partner's aggregate committed capital.

It has been suggested to the Treasury Department and the IRS that similar partner-specific expenditure issues may arise under the new partnership audit rules in section 1101 of the Bipartisan Budget Act of 2015, Public Law No. 114-74 (the BBA), which was enacted into law on November 2, 2015. Section 1101 of the BBA repeals the current rules governing partnership audits and replaces them with a new centralized partnership audit regime that, in general, assesses and collects tax at the partnership level as an imputed underpayment. Some have suggested that the manner in which an imputed underpayment is borne by partners potentially could implicate similar concerns as special allocations of partner-specific items. As the Treasury Department and the IRS continue to consider how to implement the BBA, the Treasury Department and the IRS request comments regarding whether an imputed underpayment should be included among the list of partner-specific expenditures.

### 3. Unlikely Losses

Similar to §1.514(c)-2(f), §1.514(c)-2(g) of the existing regulations generally disregards specially allocated unlikely losses or deductions (other than items of nonrecourse deduction) in computing overall partnership income or loss for purposes of the fractions rule. To be disregarded under §1.514(c)-2(g), a loss or deduction must have a low likelihood of occurring, taking into account all relevant facts, circumstances, and information available to the partners (including bona fide financial projections).

Section 1.514(c)-2(g) describes types of events that give rise to unlikely losses or deductions.

The Treasury Department and the IRS have received comments suggesting that a “more likely than not” standard is appropriate for determining when a loss or deduction is unlikely to occur. Notice 90-41 (1990-1 CB 350) (see §601.601(d)(2)(ii)(b)), which preceded the initial proposed regulations under section 514(c)(9)(E), outlined this standard. The commenter explained that the “low likelihood of occurring” standard in the existing regulations is vague and gives little comfort to QOs and their taxable partners when drafting allocations to reflect legitimate business arrangements (such as, drafting allocations to account for cost overruns). The Treasury Department and the IRS are considering changing the standard in §1.514(c)-2(g) and request further comments explaining why “more likely than not” is a more appropriate standard than the standard contained in the existing regulations, or whether another standard turning upon a level of risk that is between “more likely than not” and “low likelihood of occurring” might be more appropriate and what such other standard could be.

#### 4. Chargebacks of Partner-Specific Expenditures and Unlikely Losses

Because allocations of partner-specific expenditures in §1.514(c)-2(f) and unlikely losses in §1.514(c)-2(g) are disregarded in computing overall partnership income or loss, allocations of items of income or gain or net income to reverse the prior partner-specific expenditure or unlikely loss could cause a violation of the fractions rule. For example, a QO may contribute capital to a partnership to pay a specific expenditure with the understanding that it will receive a special allocation of income to reverse the prior expenditure once the partnership earns certain profits. If the allocation of income

is greater than the QO's fractions rule percentage, the allocation will cause a fractions rule violation.

Section 1.514(c)-2(e)(1) of the existing regulations generally disregards certain allocations of income or loss made to chargeback previous allocations of income or loss in computing overall partnership income or loss for purposes of the fractions rule. Specifically, §1.514(c)-2(e)(1)(i) disregards allocations of what would otherwise be overall partnership income that chargeback (that is, reverse) prior disproportionately large allocations of overall partnership loss (or part of the overall partnership loss) to a QO (the chargeback exception). The chargeback exception applies to a chargeback of an allocation of part of the overall partnership income or loss only if that part consists of a pro rata portion of each item of partnership income, gain, loss, and deduction (other than nonrecourse deductions, as well as partner nonrecourse deductions and compensating allocations) that is included in computing overall partnership income or loss.

The Treasury Department and the IRS understand that often a real estate partnership with QO partners may seek to reverse a special allocation of unlikely losses or partner-specific items with net profits of the partnership, which could result in allocations that would violate the fractions rule. Such allocations of net income to reverse special allocations of unlikely losses or partner-specific items that were disregarded in computing overall partnership income or loss for purposes of the fractions rule under §1.514(c)-2(f) or (g), respectively, do not violate the purpose of the fractions rule. Accordingly, the proposed regulations modify the chargeback exception to disregard in computing overall partnership income or loss for purposes of the

fractions rule an allocation of what would otherwise have been an allocation of overall partnership income to chargeback (that is, reverse) a special allocation of a partner-specific expenditure under §1.514(c)-2(f) or a special allocation of an unlikely loss under §1.514(c)-2(g). Notwithstanding the rule in the proposed regulations, an allocation of an unlikely loss or a partner-specific expenditure that is disregarded when allocated, but is taken into account for purposes of determining the partners' economic entitlement to a chargeback of such loss or expense may, in certain circumstances, give rise to complexities in determining applicable percentages for purposes of fractions rule compliance. Accordingly, the Treasury Department and the IRS request comments regarding the interaction of disregarded partner-specific expenditures and unlikely losses with chargebacks of such items with overall partnership income.

#### 5. Acquisition of Partnership Interests after Initial Formation of Partnership

Section 1.514(c)-2(k)(1) of the existing regulations provides special rules regarding changes in partnership allocations arising from a change in partners' interests. Specifically, §1.514(c)-2(k)(1) provides that changes in partnership allocations that result from transfers or shifts of partnership interests (other than transfers from a QO to another QO) will be closely scrutinized (to determine whether the transfer or shift stems from a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction), but generally will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years. Section 1.514(c)-2(k)(4) of the existing regulations provides that §1.514(c)-2 may not be applied in a manner inconsistent with the purpose of the fractions rule, which is to prevent tax avoidance by

limiting the permanent or temporary transfer of tax benefits from tax-exempt partners to taxable partners.

The Treasury Department and the IRS have received comments requesting guidance in applying the fractions rule when additional partners are admitted to a partnership after the initial formation of the partnership. The commenter explained that many real estate partnerships with QO partners admit new partners in a number of rounds of closings, but treat the partners as having entered at the same time for purposes of sharing in profits and losses (staged closings). A number of commercial arrangements are used to effect staged closings. For example, the initial operations of the partnership may be funded entirely through debt financing, with all partners contributing their committed capital at a later date. Alternatively, later entering partners may contribute capital and an interest factor, some or both of which is then distributed to the earlier admitted partners to compensate them for the time value of their earlier contributions.

Under existing regulations, staged closings could cause violations of the fractions rule in two ways. First, when new partners are admitted to a partnership, shifts of partnership interests occur. Changes in allocations that result from shifts of partnership interests are closely scrutinized under §1.514(c)-2(k)(1) of the existing regulations if pursuant to a prior agreement and could be determined to violate the fractions rule. Second, after admitting new partners, partnerships may disproportionately allocate income or loss to the partners to adjust the partners' capital accounts as a result of the staged closings. These disproportionate allocations could cause fractions rule violations if one of the partners is a QO.

The Treasury Department and the IRS have determined that changes in allocations and disproportionate allocations resulting from common commercial staged closings should not violate the fractions rule if they are not inconsistent with the purpose of the fractions rule under §1.514(c)-2(k)(4) and certain conditions are satisfied. The conditions include the following: (A) the new partner acquires the partnership interest no later than 18 months following the formation of the partnership (applicable period); (B) the partnership agreement and other relevant documents anticipate the new partners acquiring the partnership interests during the applicable period, set forth the time frame in which the new partners will acquire the partnership interests, and provide for the amount of capital the partnership intends to raise; (C) the partnership agreement and any other relevant documents specifically set forth the method of determining any applicable interest factor and for allocating income, loss, or deduction to the partners to adjust partners' capital accounts after the new partner acquires the partnership interest; and (D) the interest rate for any applicable interest factor is not greater than 150 percent of the highest applicable Federal rate, at the appropriate compounding period or periods, at the time the partnership was formed.

Under the proposed regulations, if those conditions are satisfied, the IRS will not closely scrutinize changes in allocations resulting from staged closings under §1.514(c)-2(k)(1) and will disregard in computing overall partnership income or loss for purposes of the fractions rule disproportionate allocations of income, loss, or deduction made to adjust the capital accounts when a new partner acquires its partnership interest after the partnership's formation.

#### 6. Capital Commitment Defaults or Reductions

The Treasury Department and the IRS received comments requesting guidance with respect to calculations of overall partnership income and loss when allocations change as a result of capital commitment defaults or reductions. The commenter indicated that, in the typical real estate partnership, a limited partner generally will not contribute its entire investment upon being admitted as a partner. Rather, that limited partner will commit to contribute a certain dollar amount over a fixed period of time, and the general partner will then “call” on that committed, but uncontributed, capital as needed. These calls will be made in proportion to the partners’ commitments to the partnership.

The commenter identified certain remedies that partnership agreements provide if a partner fails to contribute a portion (or all) of its committed capital. These remedies commonly include: (i) allowing the non-defaulting partner(s) to contribute additional capital in return for a preferred return on that additional capital; (ii) causing the defaulting partner to forfeit all or a portion of its interest in the partnership; (iii) forcing the defaulting partner to sell its interest in the partnership, or (iv) excluding the defaulting partner from making future capital contributions. Alternatively, the agreement may allow partners to reduce their commitment amounts, reducing allocations of income and loss as well. The commenter noted that, depending on the facts, any of these partnership agreement provisions could raise fractions rule concerns.

There is little guidance in the existing regulations regarding changes to allocations of a partner’s share of income and losses from defaulted capital calls and reductions in capital commitments. Section 1.514(c)-2(k)(1) applies to changes in allocations resulting from a default if there is a “transfer or shift” of partnership interests.

The Treasury Department and the IRS have determined that changes in allocations resulting from unanticipated defaults or reductions do not run afoul of the purpose of the fractions rule if such changes are provided for in the partnership agreement. Therefore, the proposed regulations provide that, if the partnership agreement provides for changes to allocations due to an unanticipated partner default on a capital contribution commitment or an unanticipated reduction in a partner's capital contribution commitment, and those changes in allocations are not inconsistent with the purpose of the fractions rule under §1.514(c)-2(k)(4), then: (A) changes to partnership allocations provided in the agreement will not be closely scrutinized under §1.514(c)-2(k)(1) and (B) partnership allocations of income, loss, or deduction (including allocations to adjust partners' capital accounts to be consistent with the partners' adjusted capital commitments) to partners to adjust the partners' capital accounts as a result of unanticipated capital contribution defaults or reductions will be disregarded in computing overall partnership income or loss for purposes of the fractions rule.

#### 7. Applying the Fractions Rule to Tiered Partnerships

Section 1.514(c)-2(m)(1) of the existing regulations provides that if a QO holds an indirect interest in real property through one or more tiers of partnerships (a chain), the fractions rule is satisfied if: (i) the avoidance of tax is not a principal purpose for using the tiered-ownership structure; and (ii) the relevant partnerships can demonstrate under "any reasonable method" that the relevant chains satisfy the requirements of §1.514(c)-2(b)(2) through (k). Section 1.514(c)-2(m)(2) of the existing regulations provides examples that illustrate three different "reasonable methods:" the collapsing approach, the entity-by-entity approach, and the independent chain approach.



The Treasury Department and the IRS have received comments requesting guidance with respect to tiered partnerships and the application of the independent chain approach. Under the independent chain approach in §1.514(c)-2(m)(2) Example 3 of the existing regulations, different lower-tiered partnership chains (one or more tiers of partnerships) are examined independently of each other, even if these lower-tiered partnerships are owned by a common upper-tier partnership. The example provides, however, that chains are examined independently only if the upper-tier partnership allocates the items of each lower-tier partnership separately from the items of another lower-tier partnership.

The comment noted that in practice, a real estate partnership generally invests in a significant number of properties, often through joint ventures with other partners. A typical real estate partnership will not make separate allocations to its partners of lower-tier partnership items. Accordingly, the proposed regulations amend §1.514(c)-2(m)(2) Example 3 to remove the requirement that a partnership allocate items from lower-tier partnerships separately from one another. Partnership provisions require that partnership items such as items that would give rise to UBTI be separately stated. See §1.702-1(a)(8)(ii). That requirement suffices to separate the tiers of partnerships, and, thus, the proposed regulations do not require the upper-tier partnership to separately allocate partnership items from separate lower-tier partnerships. The proposed regulations also revise §1.514(c)-2(m)(1)(ii) to remove the discussion of minimum gain chargebacks that refers to language that has been deleted from the example.

#### 8. De Minimis Exceptions from Application of the Fractions Rule

Section 1.514(c)-2(k)(2) of the existing regulations provides that the partnership limitation in section 514(c)(9)(B)(vi) does not apply to a partnership if all QOs hold a de minimis interest in the partnership, defined as no more than five percent in the capital or profits of the partnership, and taxable partners own substantial interests in the partnership through which they participate in the partnership on substantially the same terms as the QO partners. If the partnership limitation in section 514(c)(9)(B)(vi) does not apply to the partnership, the fractions rule does not apply to the partnership. Because the fractions rule does not apply to a partnership if all QOs are de minimis interest holders in the partnership, the Treasury Department and the IRS considered whether the inverse fact pattern, in which all non-QO partners are de minimis partners, implicates the purpose of the fractions rule. See §1.514(c)-2(k)(4) (providing that the purpose of the fractions rule is to “prevent tax avoidance by limiting the permanent or temporary transfer of tax benefits from tax-exempt partners to taxable partners, whether by directing income or gain to tax-exempt partners, by directing losses, deductions or credits to taxable partners, or by some similar manner.”).

The Treasury Department and the IRS have determined that the purpose of the fractions rule is similarly not violated if all non-QO partners hold a de minimis interest. Therefore, the proposed regulations provide that the fractions rule does not apply to a partnership in which non-QO partners do not hold (directly or indirectly through a partnership), in the aggregate, interests of greater than five percent in the capital or profits of the partnership, so long as the partnership’s allocations have substantial economic effect. For purposes of the proposed rule, the determination of whether an allocation has substantial economic effect is made without application of the special

rules in §1.704-1(b)(2)(iii)(c)(2) (regarding the presumption that there is a reasonable possibility that allocations will affect substantially the dollar amounts to be received by the partners from the partnership if there is a strong likelihood that offsetting allocations will not be made in five years, and the presumption that the adjusted tax basis (or book value) of partnership property is equal to the fair market value of such property).

The existing regulations also provide for a de minimis exception for allocations away from QO partners. Section 1.514(c)-2(k)(3) of the existing regulations provides that a QO's fractions rule percentage of the partnership's items of loss and deduction, other than nonrecourse and partner nonrecourse deductions, that are allocated away from the QO and to other partners in any taxable year, are treated as having been allocated to the QO for purposes of the fractions rule if: (i) the allocation was neither planned nor motivated by tax avoidance; and (ii) the total amount of those items of partnership loss or deduction is less than both one percent of the partnership's aggregate items of gross loss and deduction for the taxable year and \$50,000. The preamble to the existing final regulations under section 514(c)(9)(E) explained that the de minimis allocation exception was "to provide relief for what would otherwise be minor inadvertent violations of the fractions rule." TD 8539, 59 FR 24924. The exception was "not intended ... [to] be used routinely by partnerships to allocate some of the partnership's losses and deductions." *Id.* To that end, the final regulations limited the exception to \$50,000. As an example of a de minimis allocation intended to meet this exception, the preamble described a scenario in which a plumber's bill is paid by the partnership but overlooked until after the partner's allocations have been computed and then is allocated entirely to the taxable partner. *Id.*

In current business practices, a \$50,000 threshold does not provide sufficient relief for de minimis allocations away from the QO partner. The proposed regulations still require that allocations not exceed one percent of the partnership's aggregate items of gross loss and deduction for the taxable year, but raise the threshold from \$50,000 to \$1,000,000.

### **Proposed Applicability Date**

The regulations under section 514(c)(9)(E) are proposed to apply to taxable years ending on or after the date these regulations are published as final regulations in the **Federal Register**. However, a partnership and its partners may apply all the rules in these proposed regulations for taxable years ending on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

### **Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because these proposed regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Requests for a Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at [www.regulations.gov](http://www.regulations.gov) or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

### **Drafting Information**

The principal author of these proposed regulations is Caroline E. Hay, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income Taxes, Reporting and recordkeeping requirements.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.514(c)-2 also issued under 26 U.S.C. 514(c)(9)(E)(iii).

Par. 2. Section 1.514(c)-2 is amended by:

1. In paragraph (a), adding entries for (d)(2)(i) through (iii), adding entries for (d)(3)(i) and (ii), revising the entry for (d)(6), removing entries for (d)(6)(i) and (ii), and

(d)(7), adding entries for (k)(1)(i) through (iv), revising the entries for (k)(2)(i) and (ii), adding an entry for (k)(2)(iii), and revising the entry for (n).

2. Revising paragraphs (d)(2) and (3).
3. Removing paragraph (d)(6).
4. Redesignating paragraph (d)(7) as paragraph (d)(6).
5. Revising newly redesignated paragraph (d)(6) Example 1 paragraph (i) and adding paragraph (iv).
6. Removing the language “(i.e., reverse)” in paragraph (e)(1)(i) and adding the language “(that is, reverse)” in its place.
7. Removing the language “other partners; and” at the end of paragraph (e)(1)(iii) and adding the language “other partners;” in its place.
8. Removing the language “of §1.704-1(b)(2)(ii)(d).” at the end of paragraph (e)(1)(iv) and adding the language “of §1.704-1(b)(2)(ii)(d);” in its place.
9. Removing the language “the regulations thereunder.” at the end of paragraph (e)(1)(v) and adding the language “the regulations thereunder;” in its place.
10. Adding new paragraphs (e)(1)(vi) and (vii).
11. Adding Example 5 to paragraph (e)(5).
12. Removing the word “and” at the end of paragraph (f)(3).
13. Redesignating paragraph (f)(4) as paragraph (f)(5) and adding new paragraph (f)(4).
14. Revising paragraph (k)(1).
15. Revising the subject heading for paragraph (k)(2)(i).
16. Revising paragraph (k)(2)(i)(A).

17. Redesignating paragraph (k)(2)(ii) as paragraph (k)(2)(iii) and adding new paragraph (k)(2)(ii).

18. Revising paragraph (k)(3)(ii)(B).

19. Removing the second sentence in paragraph (m)(1)(ii).

20. Revising Example 3(ii) of paragraph (m)(2).

21. Revising the subject heading for paragraph (n).

22. Adding a sentence to the end of paragraph (n)(2).

The revisions and additions read as follows:

§1.514(c)-2. Permitted allocations under section 514(c)(9)(E).

(a) Table of contents. \* \* \*

(d) \* \* \*

(2) \* \* \*

(i) In general.

(ii) Limitation.

(iii) Distributions disregarded.

(3) \* \* \*

(i) In general.

(ii) Reasonable guaranteed payments may be deducted only when paid in cash.

\* \* \* \* \*

(6) Examples.

\* \* \* \* \*

(k) \* \* \*

(1) \* \* \*

(i) In general.

(ii) Acquisition of partnership interests after initial formation of partnership.

(iii) Capital commitment defaults or reductions.

(iv) Examples.

(2) \* \* \*

(i) Qualified organizations.

(ii) Non-qualified organizations.

(iii) Example.

\* \* \* \* \*

(n) Effective/applicability dates.

\* \* \* \* \*

(d) \* \* \*

(2) Preferred returns--(i) In general. Items of income (including gross income) and gain that may be allocated to a partner with respect to a current or cumulative reasonable preferred return for capital (including allocations of minimum gain attributable to nonrecourse liability (or partner nonrecourse debt) proceeds distributed to the partner as a reasonable preferred return) are disregarded in computing overall partnership income or loss for purposes of the fractions rule. Similarly, if a partnership agreement effects a reasonable preferred return with an allocation of what would otherwise be overall partnership income, those items comprising that allocation are disregarded in computing overall partnership income for purposes of the fractions rule.

(ii) Limitation. Except as otherwise provided in paragraph (d)(2)(iii) of this section, items of income and gain (or part of what would otherwise be overall partnership income) that may be allocated to a partner in a taxable year with respect to a reasonable preferred return for capital are disregarded under paragraph (d)(2)(i) of this section for purposes of the fractions rule only if the partnership agreement requires the partnership to make distributions first to pay any accrued, cumulative, and compounding unpaid preferred return to the extent such accrued but unpaid preferred return has not otherwise been reversed by an allocation of loss prior to such distribution.

(iii) Distributions disregarded. A distribution is disregarded for purposes of paragraph (d)(2)(ii) of this section if the distribution—

(A) Is made pursuant to a provision in the partnership agreement intended to facilitate the partners' payment of taxes imposed on their allocable shares of partnership income or gain;



(B) Is treated as an advance against distributions to which the distributee partner would otherwise be entitled under the partnership agreement; and

(C) Does not exceed the distributee partner's allocable share of net partnership income and gain multiplied by the sum of the highest statutory federal, state, and local tax rates applicable to such partner.

(3) Guaranteed payments--(i) In general. A current or cumulative reasonable guaranteed payment to a qualified organization for capital or services is treated as an item of deduction in computing overall partnership income or loss, and the income that the qualified organization may receive or accrue from the current or cumulative reasonable guaranteed payment is not treated as an allocable share of overall partnership income or loss. The treatment of a guaranteed payment as reasonable for purposes of section 514(c)(9)(E) does not affect its possible characterization as unrelated business taxable income under other provisions of the Internal Revenue Code.

(ii) Reasonable guaranteed payments may be deducted only when paid in cash. If a partnership that avails itself of paragraph (d)(3)(i) of this section would otherwise be required (by virtue of its method of accounting) to deduct a reasonable guaranteed payment to a qualified organization earlier than the taxable year in which it is paid in cash, the partnership must delay the deduction of the guaranteed payment until the taxable year it is paid in cash. For purposes of this paragraph (d)(3)(ii), a guaranteed payment that is paid in cash on or before the due date (not including extensions) for filing the partnership's return for a taxable year may be treated as paid in that prior taxable year.

\* \* \* \* \*

(6) \* \* \*

Example 1. \* \* \*

(i) The partnership agreement provides QO a 10 percent preferred return on its unreturned capital. The partnership agreement provides that the preferred return may be compounded (at 10 percent) and may be paid in future years and requires that when distributions are made, they must be made first to pay any accrued, cumulative, and compounding unpaid preferred return not previously reversed by a loss allocation. The partnership agreement also allows distributions to be made to facilitate a partner's payment of federal, state, and local taxes. Under the partnership agreement, any such distribution is treated as an advance against distributions to which the distributee partner would otherwise be entitled and must not exceed the partner's allocable share of net partnership income or gain for that taxable year multiplied by the sum of the highest statutory federal, state, and local tax rates applicable to the partner. The partnership agreement first allocates gross income and gain 100 percent to QO, to the extent of the preferred return. All remaining income or loss is allocated 50 percent to QO and 50 percent to TP.

\* \* \* \* \*

(iv) The facts are the same as in paragraph (i) of this Example 1, except the partnership makes a distribution to TP of an amount computed by a formula in the partnership agreement equal to TP's allocable share of net income and gain multiplied by the sum of the highest statutory federal, state, and local tax rates applicable to TP. The partnership satisfies the fractions rule. The distribution to TP is disregarded for purposes of paragraph (d)(2)(ii) of this section because the distribution is made pursuant to a provision in the partnership agreement that provides that the distribution is treated as an advance against distributions to which TP would otherwise be entitled and the distribution did not exceed TP's allocable share of net partnership income or gain for that taxable year multiplied by the sum of the highest statutory federal, state, and local tax rates applicable to TP. The income and gain that is specially allocated to QO with respect to its preferred return is disregarded in computing overall partnership income or loss for purposes of the fractions rule because the requirements of paragraph (d) of this section are satisfied. After disregarding those allocations, QO's fractions rule percentage is 50 percent (see paragraph (c)(2) of this section), and, under the partnership agreement, QO may not be allocated more than 50 percent of overall partnership income in any taxable year.

(e) \* \* \*

(1) \* \* \*

(vi) Allocations of what would otherwise be overall partnership income that may be made to chargeback (that is, reverse) prior allocations of partner-specific expenditures that were disregarded in computing overall partnership income or loss for purposes of the fractions rule under paragraph (f) of this section; and

(vii) Allocations of what would otherwise be overall partnership income that may be made to chargeback (that is, reverse) prior allocations of unlikely losses and deductions that were disregarded in computing overall partnership income or loss for purposes of the fractions rule under paragraph (g) of this section.

\* \* \* \* \*

(5) \* \* \*

Example 5. Chargeback of prior allocations of unlikely losses and deductions. (i) Qualified organization (QO) and taxable corporation (TP) are equal partners in a partnership that holds encumbered real property. The partnership agreement generally provides that QO and TP share partnership income and deductions equally. QO contributes land to the partnership, and the partnership agreement provides that QO bears the burden of any environmental remediation required for that land, and, as such, the partnership will allocate 100 percent of the expense attributable to the environmental remediation to QO. In the unlikely event of the discovery of environmental conditions that require remediation, the partnership agreement provides that, to the extent its cumulative net income (without regard to the remediation expense) for the taxable year the partnership incurs the remediation expense and for subsequent taxable years exceeds \$500x, after allocation of the \$500x of cumulative net income, net income will first be allocated to QO to offset any prior allocation of the environmental remediation expense deduction. On January 1 of Year 3, the partnership incurs a \$100x expense for the environmental remediation of the land. In that year, the partnership had gross income of \$60x and other expenses of \$30x for total net income of \$30x without regard to the expense associated with the environmental remediation. The partnership allocated \$15x of income to each of QO and TP and \$100x of remediation expense to QO.

(ii) The partnership satisfies the fractions rule. The allocation of the expense attributable to the remediation of the land is disregarded under paragraph (g) of this section. QO's share of overall partnership income is 50 percent, which equals QO's share of overall partnership loss.

(iii) In Year 8, when the partnership's cumulative net income (without regard to the remediation expense) for the taxable year the partnership incurred the remediation expense and subsequent taxable years is \$480x (the \$30x from Year 3, plus \$450x of cumulative net income for Years 4-7), the partnership has gross income of \$170x and expenses of \$50x, for total net income of \$120x. The partnership's cumulative net income for all years from Year 3 to Year 8 is \$600x (\$480x for Years 3-7 and \$120x for Year 8). Pursuant to the partnership agreement, the first \$20x of net income for Year 8 is allocated equally between QO and TP because the partnership must first earn cumulative net income in excess of \$500x before making the offset allocation to QO. The remaining \$100x of net income for Year 8 is allocated to QO to offset the environmental remediation expense allocated to QO in Year 3.

(iv) Pursuant to paragraph (e)(1)(vii) of this section, the partnership's allocation of \$100x of net income to QO in Year 8 to offset the prior environmental remediation expense is disregarded in computing overall partnership income or loss for purposes of the fractions rule. The allocation does not cause the partnership to violate the fractions rule.

(f) \* \* \*

(4) Expenditures for management and similar fees, if such fees in the aggregate for the taxable year are not more than 2 percent of the partner's capital commitments; and \* \* \*

\* \* \* \* \*

(k) Special rules--(1) Changes in partnership allocations arising from a change in the partners' interests--(i) In general. A qualified organization that acquires a partnership interest from another qualified organization is treated as a continuation of the prior qualified organization partner (to the extent of that acquired interest) for purposes of applying the fractions rule. Changes in partnership allocations that result from other transfers or shifts of partnership interests will be closely scrutinized (to determine whether the transfer or shift stems from a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction), but

generally will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years.

(ii) Acquisition of partnership interests after initial formation of partnership.

Changes in partnership allocations due to an acquisition of a partnership interest by a partner (new partner) after the initial formation of a partnership will not be closely scrutinized under paragraph (k)(1)(i) of this section, but will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years, and disproportionate allocations of income, loss, or deduction to the partners to adjust the partners' capital accounts as a result of, and to reflect, the new partner acquiring the partnership interest and the resulting changes to the other partners' interests will be disregarded in computing overall partnership income or loss for purposes of the fractions rule if such changes and disproportionate allocations are not inconsistent with the purpose of the fractions rule under paragraph (k)(4) of this section and—

(A) The new partner acquires the partnership interest no later than 18 months following the formation of the partnership (applicable period);

(B) The partnership agreement and other relevant documents anticipate the new partners acquiring the partnership interest during the applicable period, set forth the time frame in which the new partners will acquire the partnership interests, and provide for the amount of capital the partnership intends to raise;

(C) The partnership agreement and other relevant documents specifically set forth the method for determining any applicable interest factor and for allocating income, loss, or deduction to the partners to account for the economics of the arrangement in

the partners' capital accounts after the new partner acquires the partnership interest;  
and

(D) The interest rate for any applicable interest factor is not greater than 150 percent of the highest applicable Federal rate, at the appropriate compounding period or periods, at the time the partnership was formed.

(iii) Capital commitment defaults or reductions. Changes in partnership allocations that result from an unanticipated partner default on a capital contribution commitment or an unanticipated reduction in a partner's capital contribution commitment, that are effected pursuant to provisions prescribing the treatment of such events in the partnership agreement, and that are not inconsistent with the purpose of the fractions rule under paragraph (k)(4) of this section, will not be closely scrutinized under paragraph (k)(1)(i) of this section, but will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years. In addition, partnership allocations of income, loss, or deduction to partners made pursuant to the partnership agreement to adjust partners' capital accounts as a result of unanticipated capital contribution defaults or reductions will be disregarded in computing overall partnership income or loss for purposes of the fractions rule. The adjustments may include allocations to adjust partners' capital accounts to be consistent with the partners' adjusted capital commitments.

(iv) Examples. The following examples illustrate the provisions of paragraph (k)(1) of this section.

Example 1. Staged closing. (i) On July 1 of Year 1, two taxable partners (TP1 and TP2) form a partnership that will invest in debt-financed real property. The

partnership agreement provides that, within an 18-month period, partners will be added so that an additional \$1000x of capital can be raised. The partnership agreement sets forth the method for determining the applicable interest factor that complies with paragraph (k)(1)(ii)(D) of this section and for allocating income, loss, or deduction to the partners to account for the economics of the arrangement in the partners' capital accounts. During the partnership's Year 1 taxable year, partnership had \$150x of net income. TP1 and TP2, each, is allocated \$75x of net income.

(ii) On January 1 of Year 2, qualified organization (QO) joins the partnership. The partnership agreement provides that TP1, TP2, and QO will be treated as if they had been equal partners from July 1 of Year 1. Assume that the interest factor is treated as a reasonable guaranteed payment to TP1 and TP2, the expense from which is taken into account in the partnership's net income of \$150x for Year 2. To balance capital accounts, the partnership allocates \$100x of the income to QO (\$50x, or the amount of one-third of Year 1 income that QO was not allocated during the partnership's first taxable year, plus \$50x, or one-third of the partnership's income for Year 2) and the remaining income equally to TP1 and TP2. Thus, the partnership allocates \$100x to QO and \$25x to TP1 and TP2, each.

(iii) The partnership's allocation to QO would violate the fractions rule because QO's overall percentage of partnership income for Year 2 of 66.7 percent is greater than QO's fractions rule percentage of 33.3 percent. However, the special allocation of \$100x to QO for Year 2 is disregarded in determining QO's percentage of overall partnership income for purposes of the fractions rule because the requirements in paragraph (k)(1)(ii) of this section are satisfied.

Example 2. Capital call default. (i) On January 1 of Year 1, two taxable partners, (TP1 and TP2) and a qualified organization (QO) form a partnership that will hold encumbered real property and agree to share partnership profits and losses, 60 percent, 10 percent, and 30 percent, respectively. TP1 agreed to a capital commitment of \$120x, TP2 agreed to a capital commitment of \$20x, and QO agreed to a capital commitment of \$60x. The partners met half of their commitments upon formation of the partnership. The partnership agreement requires a partner's interest to be reduced if the partner defaults on a capital call. The agreement also allows the non-defaulting partners to make the contribution and to increase their own interests in the partnership. Following a capital call default, the partnership agreement requires allocations to adjust capital accounts to reflect the change in partnership interests as though the funded commitments represented the partner's interests from the partnership's inception.

(ii) In Year 1, partnership had income of \$100x, which was allocated to the partners \$60x to TP1, \$10x to TP2, and \$30x to QO.

(iii) In Year 2, partnership required each partner to contribute the remainder of its capital commitment, \$60x from TP1, \$10x from TP2, and \$30x from QO. TP1 could not make its required capital contribution, and QO contributed \$90x, its own capital commitment, in addition to TP1's. TP1's default was not anticipated. As a result and

pursuant to the partnership agreement, TP1's interest was reduced to 30 percent and QO's interest was increased to 60 percent. Partnership had income of \$60x and losses of \$120x in Year 2, for a net loss of \$60x. Partnership allocated to TP1 \$48x of loss (special allocation of \$30x of gross items of loss to adjust capital accounts and \$18x of net loss (30 percent of \$60x net loss)), TP2 \$6x of net loss (10 percent of \$60x net loss), and QO \$6x of loss (special allocation of \$30x of gross items of income to adjust capital accounts - \$36x of net loss (60 percent of \$60x net loss)). At the end of Year 2, TP1's capital account equals \$72x (capital contribution of \$60x + \$60x income from Year 1 - \$48x loss from Year 2); TP2's capital account equals \$24x (capital contributions of \$20x + \$10x income from Year 1 - \$6x loss from Year 2); and QO's capital account equals \$144x (capital contributions of \$120x (\$30x + \$90x) + \$30x income from Year 1 - \$6x loss from Year 2).

(iv) The changes in partnership allocations to TP1 and QO due to TP1's unanticipated default on its capital contribution commitment were effected pursuant to provisions prescribing the treatment of such events in the partnership agreement. Therefore these changes in allocations will not be closely scrutinized under paragraph (k)(1)(i) of this section, but will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years. In addition, pursuant to paragraph (k)(1)(iii) of this section, the special allocations of \$30x additional loss to TP1 and \$30x additional income to QO to adjust their capital accounts to reflect their new interests in the partnership are disregarded when calculating QO's percentage of overall partnership income and loss for purposes of the fractions rule.

(2) \* \* \*

(i) Qualified organizations. \* \* \*

(A) Qualified organizations do not hold (directly or indirectly through a partnership), in the aggregate, interests of greater than five percent in the capital or profits of the partnership; and

\* \* \* \* \*

(ii) Non-qualified organizations. Section 514(c)(9)(B)(vi) does not apply to a partnership otherwise subject to that section if—



(A) All partners other than qualified organizations do not hold (directly or indirectly through a partnership), in the aggregate, interests of greater than five percent in the capital or profits of the partnership; and

(B) Allocations have substantial economic effect without application of the special rules in §1.704-1(b)(2)(iii)(c) (regarding the presumption that there is a reasonable possibility that allocations will affect substantially the dollar amounts to be received by the partners from the partnership if there is a strong likelihood that offsetting allocations will not be made in five years, and the presumption that the adjusted tax basis (or book value) of partnership property is equal to the fair market value of such property).

\* \* \* \* \*

(3) \* \* \*

(ii) \* \* \*

(B) \$1,000,000.

\* \* \* \* \*

(m) \* \* \*

(2) \* \* \*

Example 3. \* \* \*

(ii) P2 satisfies the fractions rule with respect to the P2/P1A chain. See §1.702-1(a)(8)(ii) (for rules regarding separately stating partnership items). P2 does not satisfy the fractions rule with respect to the P2/P1B chain.

(n) Effective/applicability dates. \* \* \*

(2) \* \* \* However, paragraphs (d)(2)(ii) and (iii), (d)(6) Example 1(i) and (iv), (e)(1)(vi) and (vii), (e)(5) Example 5, (f)(4), (k)(1)(ii) through (iv), (k)(2)(i)(A), (k)(2)(ii), (k)(3)(ii)(B), (m)(1)(ii), and (m)(2) Example 3(ii) of this section apply to taxable years ending on or after the date these regulations are published as final regulations in the **Federal Register**.

\* \* \* \* \*

John Dalrymple

Deputy Commissioner for Services and Enforcement.

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